Prabhudas Lilladher

Hindustan Unilever

Share buy-back; a limited reprieve

Event Update

June 7, 2010

Rating	**Sell**
Price	Rs247
Target Price	Rs218
Implied Upside	(-) 11.8%
Sensex	17,022

(Prices as on June 4, 2010)

Trading Data

Market Cap. (Rs bn)	538.9
Shares o/s (m)	2,179.9
Free Float	47.98%
3M Avg. Daily Vol ('000)	3,375.3
3M Avg. Daily Value (Rs m)	785.9

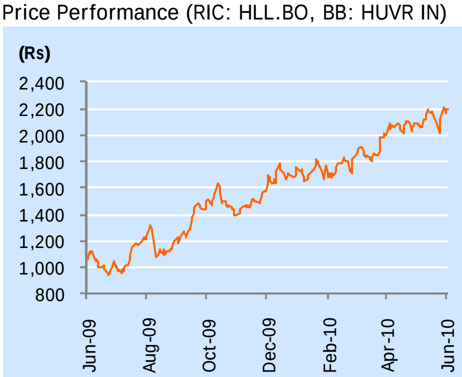
Major Shareholders

Promoters	52.02%
Foreign	14.48%
Domestic Inst.	14.10%
Public & Others	19.40%

Stock Performance

(%)	1M	6M	12M
Absolute	5.5	(9.0)	(1.5)
Relative	5.7	(7.5)	(12.1)

Price Performance (RIC: HLL.BO, BB: HUVR IN)



Source: Bloomberg

Hindustan Unilever's (HUVR's) share buy-back announcement may provide a temporary floor to the stock price. We don't share market's optimism/excitement on HUVR's new found aggression as we reckon that the new initiatives (aggressive brand spends, new launches, entry into new categories etc.) will not make any material difference, given HUVR's size. We view share buy-back as a good exit opportunity as we believe that elevated levels of competition, coupled with rising input costs, increased royalty payments and limited pricing power will keep the earnings growth depressed for another year.

- **The buy-back announcement:** HUVR has announced its board meeting on June 11, 2010 to mull over share buy-back. As per current regulations, it can spend upto 25% of its networth (~Rs6bn) for buy-back. Details of the buy-back programme (price, quantity of shares etc) are yet to be announced. However, it is expected to be in the range of 1-1.2% of its outstanding equity assuming three different scenarios as regards buy-back price viz. a) CMP of Rs247 b) at 15% premium to 6-months average price (like in previous buy-back in July 2007) or c) at 10% premium to 6-months average price.

- **The earlier share buy-back in 2007:** In the previous buy-back offer which was announced on July 29, 2007 and which commenced on October 3, 2007 and culminated on January 31, 2008, HUVR had bought 3.02m shares from the open market at an average price of Rs207.1 (buy-back offer was upto a price not exceeding Rs230). HUVR used Rs6.3bn of the networth for this and Unilever's stake went up from 51.42% to 52.12% post the buy-back.

- **Focus to return on fundamentals, good exit opportunity, reiterate SELL:** While we expect the buy-back announcement to provide temporary floor to the stock price, we view it as a non-event and expect the focus to return to fundamentals soon, which in our view still remains a concern owing to our expectations of A) Continued elevated levels of competitive intensity not only from Procter & Gamble (P&G) which we expect will step-up its intensity in the second half of CY10 but also from ITC in the household and personal care space which has garnered 5% and 3.5% market share in soaps and shampoos, respectively. B) Long, grinding and expensive route to volume and market share recovery and consequently, c) Depressed earnings growth outlook. Q1FY11 results of HUVR will be crucial as it will show the full impact of 1) Price cuts 2) Higher excise and royalty payments as well as 3) Higher input costs. While HUVR has so far managed operating margins through excellent cost control initiatives, we see limited incremental upside from the same. We reiterate '**SELL**' and maintain our target price of Rs218.

Key financials (Y/e March)	FY09	FY10	FY11E	FY12E
Revenues (Rs m)	205,011	175,798	192,388	215,699
Growth (%)	*47.8*	*(14.2)*	*9.4*	*12.1*
EBITDA (Rs m)	27,029	27,420	28,593	32,144
PAT (Rs m)	24,900	21,229	22,168	25,028
EPS (Rs)	11.4	9.7	10.2	11.5
Growth (%)	*43.1*	*(14.7)*	*4.4*	*12.9*
Net DPS (Rs)	7.5	7.8	8.1	9.2

Source: Company Data; PL Research

Profitability & valuation	FY09	FY10	FY11E	FY12E
EBITDA margin (%)	*13.3*	*15.7*	*14.9*	*15.0*
RoE (%)	*136.6*	*96.3*	*94.6*	*100.4*
RoCE (%)	*133.6*	*97.1*	*96.7*	*104.4*
EV / sales (x)	2.5	2.9	2.7	2.4
EV / EBITDA (x)	19.2	18.9	18.1	16.1
PE (x)	21.6	25.4	24.3	21.5
P / BV (x)	25.2	23.7	22.3	20.9
Net dividend yield (%)	*3.0*	*3.2*	*3.3*	*3.7*

Source: Company Data; PL Research

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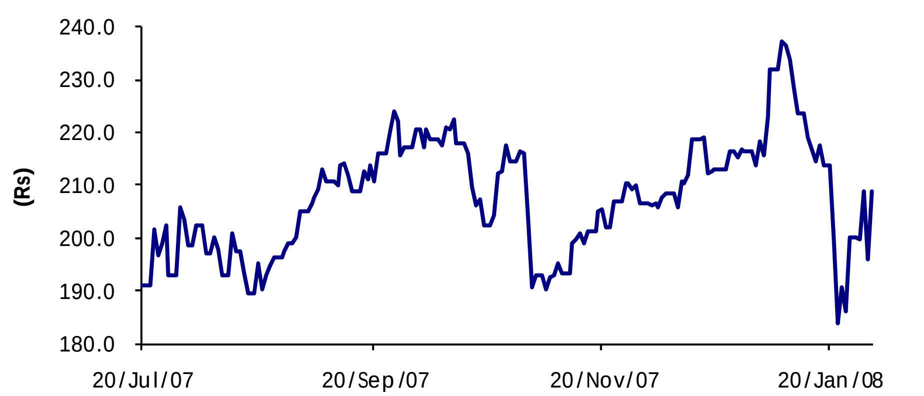
Buy-back to provide temporary relief to stock price

We believe HUVR's share buy-back announcement will act as a temporary relief to stock price and expect the focus of the investors to return soon to the weak fundamentals in a deteriorating competitive environment. Exact details of the buy-back offer viz. price, quantity of the shares, route of the buy-back programme (tender offer, open market purchase etc) are yet to be announced. As per the current regulations, upto 25% of the networth can be utilized for share buy-back. For HUVR, it translated to ~Rs6.6bn, given its FY10E networth of Rs26.5bn. In the previous buy-back, price cap for buy-back was set at Rs230, a 15% premium to the 6 months average price before announcement. Assuming similar premium, price cap for the current offer will work out to Rs280. At this price, HUVR can buy-back 1.04% of its outstanding equity.

In the previous offer, HUVR had bought 3.02m shares from the open market at an average price of Rs207.1 (10% lower than the cap price of Rs230), spending nearly Rs6.3bn. Post announcement of buy-back, while the stock did react positively, excitement came down in a couple of days as reflected in the chart below. It shows the performance of HUVR stock from the date of announcement of board meeting to discuss buy-back on July 20, 2007 to the conclusion of the offer on January 31, 2008.

HUVR share price performance during previous buy-back offer



Source: Bloomberg, PL Research

New initiatives, though a welcome change, will take time to make a material impact

HUVR's new found aggression in defending its market shares and volumes at any cost, though positive from a longer term perspective, will extract its cost in terms of higher ad spends and limited pricing flexibility, given the increasingly deteriorating competitive environment in the household and personal care space. Not only P&G, ITC too will pose a significant threat to HUVR's market shares in the medium term. ITC has tasted blood with a 5% and 3.5% market shares in Soaps and Shampoos, respectively as on March 31, 2010. Given ITC's deep pockets and ability to build brands as well as sustain investments/losses, we believe ITC will continue to pose a threat to all the incumbents.

HUVR has responded to the rising competition with a series of actions including price cuts, heavy ad spends as well as trade promotions, re-launches across the categories, deployment of full portfolio as against the earlier unsuccessful power brand strategy, enhanced focus on the mass end of portfolio and greater focus on foods category. HUVR is also targeting to triple its rural distribution reach in the next two-three years to capture the ever-evolving rural opportunity. During the recently held analyst meet, management has reiterated its focus on defending its market share and volumes as well as playing the full portfolio to leverage its presence across the price pyramid.

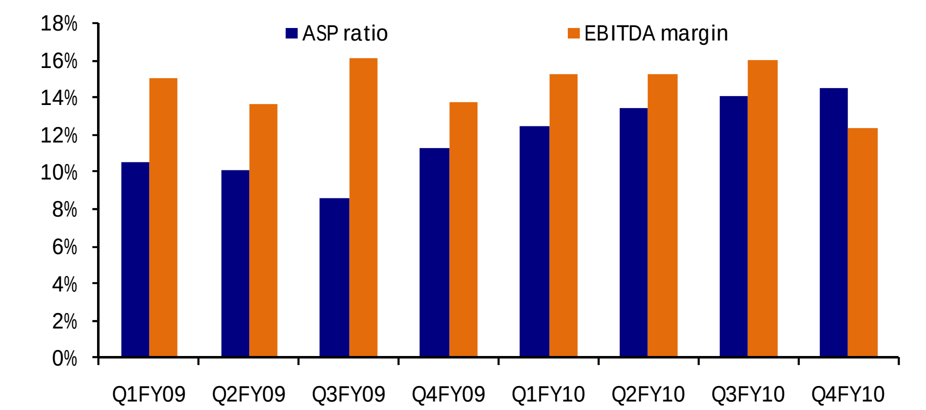
HUVR's recent launches include a) 'Brooke-bond Sehatmand' tea b) 'Knorr' Soupy Noodles c) 'Sure' anti-perspirant deodorant 4) 'Comfort' fabric softener 5) 'Vaseline' Men's range of skin care products. We like HUVR's focus on driving growth in the under-penetrated and high growth categories like Packaged Foods and top-end Personal Care. Management believes that opportunity in packaged foods still remains significant even though its presence is limited in niche packaged foods categories. Similarly, consumption and penetration led opportunity exists in personal care, which, HUVR expects to leverage, given its strong presence across the price spectrum. Case in point being Dove which exploded from being a Rs750m brand in 2007 to Rs5bn brand in 2010.

While this is a welcome change from the past as well as from longer term market dominance perspective, it has come a tad late and may not suffice, in our view. Given HUVR's size, all the initiatives which it is taking, even though successful, will add limited muscle to HUVR's top-line. Nearly 40% of HUVR's turnover still accrues from highly penetrated, mature and hence, low growth categories like Soaps and Detergents, limiting the overall volume and revenue growth. This has been one of our key reasons for the bearish view on HUVR since our initiation ("The Rising Tide", dated 10-12-2009)

Structural change in competitive environment will act as margin depressant in the medium term

Another key change is the structural change in competitive environment with domestic as well as MNC players looking to grab a share in the Indian FMCG market which is attractively poised given the favourable demographics. Case in point being ITC, which in a three years time, has grabbed a decent 5% and 3.5% market share in Soaps and Shampoos, respectively. Given its focus on ramping up the distribution presence and desire to enter new personal care categories, we see ITC as a significant threat apart from P&G which has already stepped up the ladder in the competitive intensity. Similarly, we expect P&G to raise the competitive bar further in H2CY10 with a series of new initiatives. All this will put pressure on HUVR's already high ad spends. Also, it will impact the pricing power in a rising input cost environment. We forecast an 80 bps decline in FY11e EBITDA margins.

Ad Spends to remain high



Source: Company Data, PL Research

Q1FY11 results will be crucial to gauge the impact of price cuts, high input cost etc on EBITDA margins

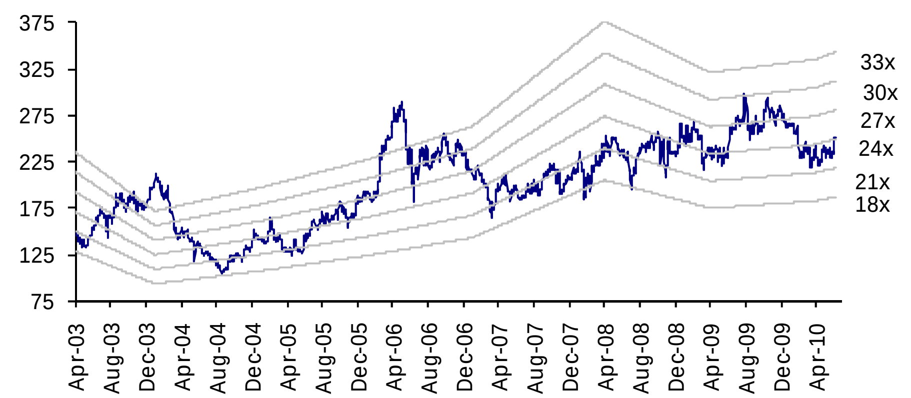
We believe Q1FY11 results of HUVR will be crucial as it will give a true picture of the full impact of price cuts implemented by HUVR in laundry category as well as the trade promotions in the Shampoo space. Volume growth is likely to be strong, given the low base as well as slew of price cuts and trade promotions. It will also be crucial from gross margins view point as low cost input inventory is likely to have exhausted in Q4FY10. Continued higher ad spends and increased royalty payments can have a significant impact on operating margins.

HUVR has implemented several cost control initiatives which have yielded desired results in the last three quarters (employee costs as well as other expenditure as a% of sales have declined). However, we see limited incremental upside from cost control measures, going ahead.

Reiterate SELL; Buy-back offer presents a good exit opportunity

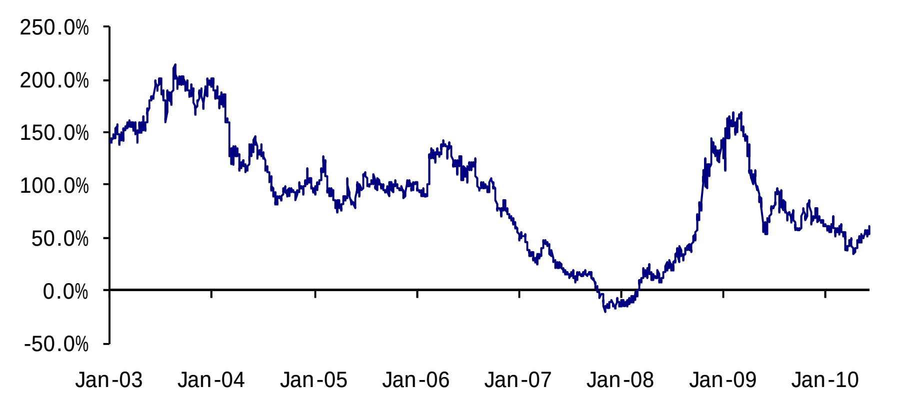
Owing to the factors discussed above, we believe HUVR's earnings growth for FY11E will be depressed. We forecast 4% earnings growth in FY11E. However, we believe risks to our earnings exist on downside as lack of pricing power in a rising input costs environment may throw negative earnings surprises, going ahead.

Expensive valuations for sub-par earnings growth



Source: Bloomberg, PL Research

Declining premium to sensex



Source: Bloomberg, PL Research

Valuations at 24.5x FY11E are expensive for a weak earnings growth profile and potentially worsening competitive landscape. We reiterate 'Sell', with a target price of Rs218.

Upside risks to our rating:

- Moderation in competitive intensity, leading to a decline in ad spends which will positively impact operating margins and earnings growth.
- Return of pricing power.
- HUVR can outperform if the markets continue to remain volatile owing to various factors like Europe etc.

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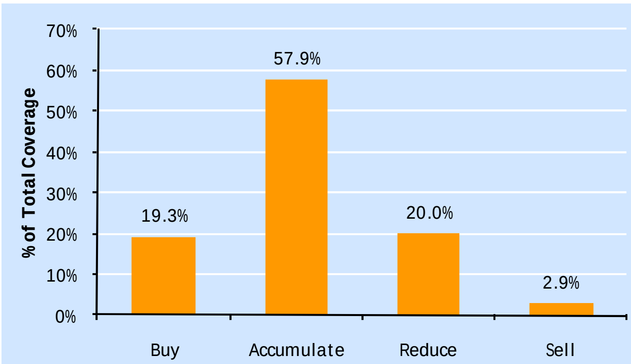
Rating Distribution of Research Coverage



PL's Recommendation Nomenclature

BUY	:	Over 15% Outperformance to Sensex over 12-months	**Accumulate**	:	Outperformance to Sensex over 12-months
Reduce	:	Underperformance to Sensex over 12-months	**Sell**	:	Over 15% underperformance to Sensex over 12-months
Trading Buy	:	Over 10% absolute upside in 1-month	**Trading Sell**	:	Over 10% absolute decline in 1-month
Not Rated (NR)	:	No specific call on the stock	**Under Review (UR)**	:	Rating likely to change shortly

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